RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

SINCE 1958 •

POST OFFICE BOX 1759, LA JOLLA, CALIFORNIA 92038
26 LETTERS PER YEAR • $225 ANNUALLY

Oct. 4, 1989 **LETTER 1027**

Sept. 22 DJIA 2681.61; PTI 3234; A-D Ratio -6.38
Sept. 29 DJIA 2692.82; PTI 3249; A-D Ratio -6.31
Dow Yield: 3.74%; Dow P/E: 11.9; DowPow: 1092
Dow Book Value: 1075; Dow 200-day MA: 2436
Percentage of Undervalued Blue-chips: 14%

THE PICTURE: For value-minded investors with a sense of history the current market presents a difficult and unusual dilemma. The S&P Composite now sells at 30.3 times its dividends. My friends at *Growth Fund Guide* point out: "There have been 17 other Price/Dividend ratio peaks recorded in the 30-and-above area since 1871, and they were all followed by declines that averaged 36.6%."

Of course, we don't know when or where the final peak for the Price/Dividend ratio will come, but any time the ratio is over 30 (as now), history tells us that we're treading on thin ice.

And yet -- despite the rarefied investment atmosphere, my Primary Trend Index (PTI) keeps pushing to new highs. What does it all mean, and what should we do about it? Let me put it this way. When the primary trend of this market finally does turn bearish, I would expect my PTI to enter a long and persistent downtrend. It just has not done that yet -- despite overvaluation, despite a dangerous looking parabolic rise in the Transportation Average, and despite the dramatic drop-off in daily new highs.

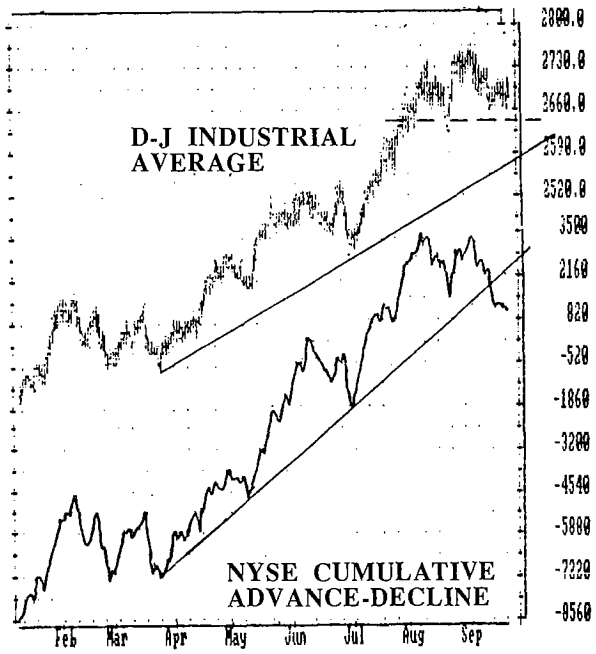
Another study is confirming the action of my PTI. I follow the McClellan and Summation Indices (they're based on exponential moving averages of the daily breadth), and these two indices are becoming oversold. In fact, the Summation Index (amazingly) has now moved to its lowest, or most oversold, level since the 1987 crash.

Thus, the action of the PTI and the Summation Index would seem to be suggesting another market advance starting somewhere between now and the end of October. Will the advance take the Averages to new highs -- or will it be the rally that forms the final top? There's no way of knowing -- but I do know that this market is becoming oversold and quite resistant to lower prices.

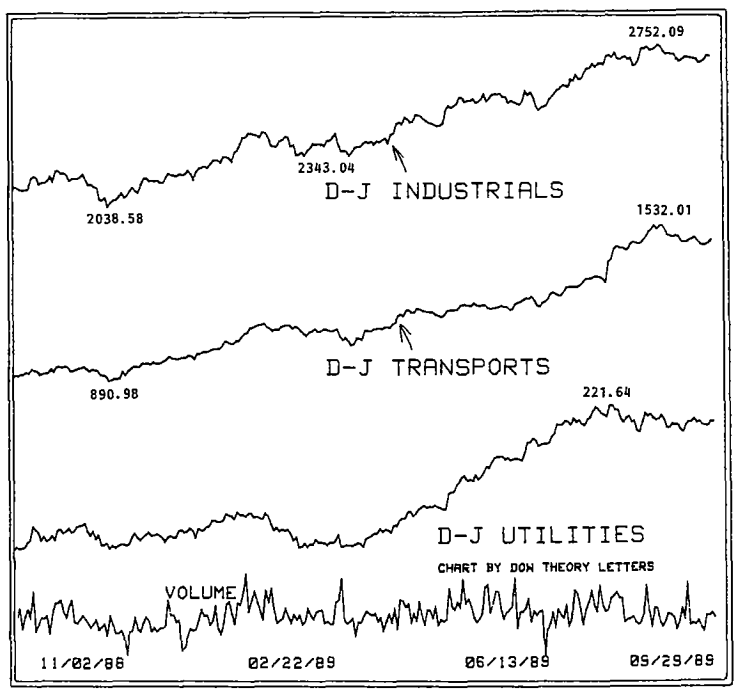
Personally, I'm playing it rather conservatively at this time. Using my own accounts as a guide, this means about 75% in a muni cash fund, about 5% in gold coins and the rest in no-load stock funds plus a few individual bonds to round out the portfolio. I'll probably sit tight with this mix unless or until the PTI turns decisively down or until I've received definitively bearish signals from the Averages.

The D-J Average highs for 1989 were recorded in early September with the D-J Industrials at 2752.09 and the Transports at 1532.01. The Utility Average recorded a 1989 high of 221.64, but it is interesting to note that the Utilities never did get above their 1987 bull market high of 227.83.

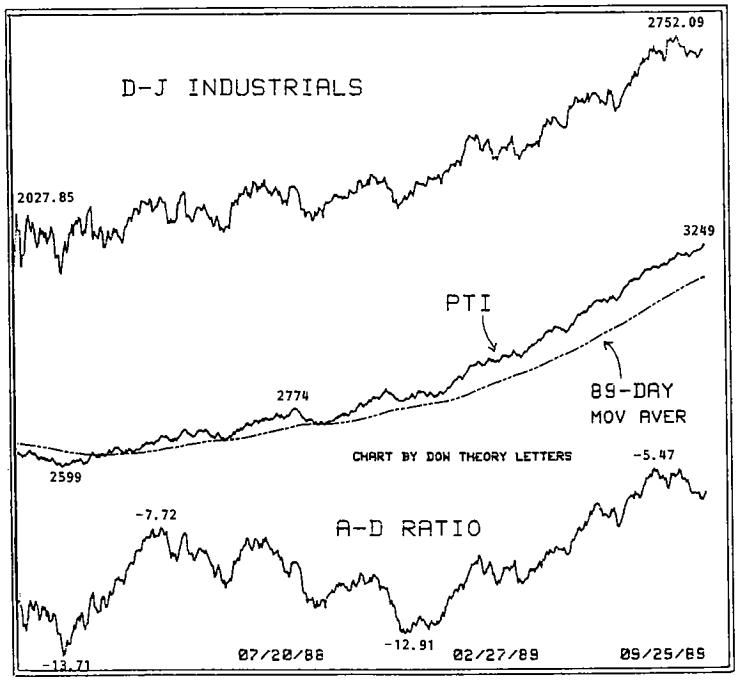
Since the highs, the Averages have come down, but the downside has seemed labored. We haven't seen any bouts of intense selling pressure yet -- but, of course, this can be a fooler. Important declines can begin with a simple drop-off in buying power. Then, as prices recede (amid continuing optimism), selling pressure slowly builds up. Then, just when you thought it was all right to hold on to your fat portfolio of stocks, the selling pressure comes in, and the losses start building in earnest.



The accompanying chart (courtesy of *Smith Barney*) may give us a good insight into what's happening in the market. Here we see the



Sorreeey! Big mistake in gold section of last Letter. Three tons of gold should read a current $34,560,000, not the $450 billion that was stated. I took the quote from an article in a local newspaper, the article was wrong, and I (lazily) did not check it. Sorry.



Dow forming a potential "head-and-shoulders" top -- but nevertheless holding above a five-month rising trendline and also holding above near-term support (i.e., the support is the horizontal dashed line at Dow 2647). At the same time the advance-decline line has broken below its August low and also violated its own rising trendline.

Thus, we have a picture of weakness in the general market (as measured by the A-D ratio) and resistance or strength in the Dow. In this type of situation, I would normally expect a Dow rally, which would serve to relieve the over-sold condition of the market. But following the rally, I would expect the Dow to follow the A-D ratio down. A signal telling us that the Dow was confirming the weakness in the A-D ratio would be the Dow breaking below the August low of **2647.**

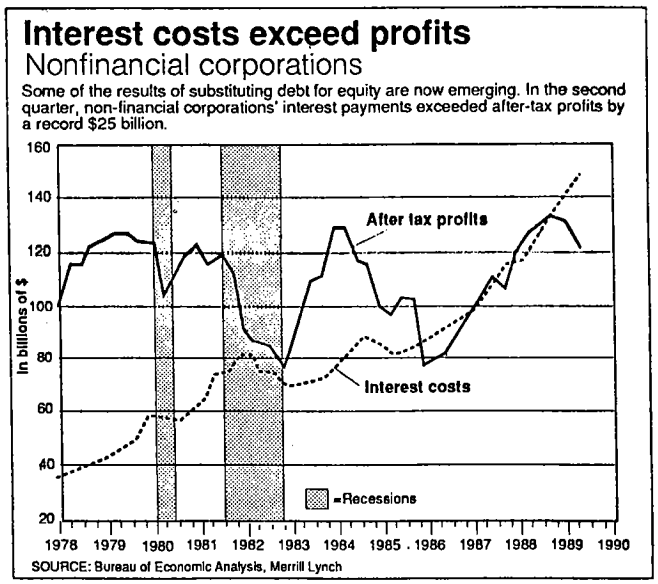
INVESTMENT POSITION: The bull is in the box. The bull's nervous ticks are a result of his worrying about market overvaluation. Nevertheless, he is a bull, and that's important to remember (if you're tempted to go short, mark this well).

My own position in the markets was outlined on page 1. I think the market is going to be erratic from here, but my guess is that Wall Street is building a top. That's going to take time. One definite plus in the current picture is the stock market's seeming immunity to bad news. Huge bank write-offs, bad news from IBM, declining tool orders, the S&L fiasco, the HUD mess -- none of this has served to crack this market, and that's impressive and a sign of strength.

CHARTS: Here are three charts that I would like my subscribers to study. The first is a genuine shocker. It traces the relationship between (nonfinancial) corporate profits and (nonfinancial) corporate interest costs. The chart goes back to 1978.

Note in the two previous recessions (shaded areas), even though corporate profits declined sharply, profits nevertheless held well above total interest costs. But today, even before any recession, total interest costs have actually climbed well above corporate profits.

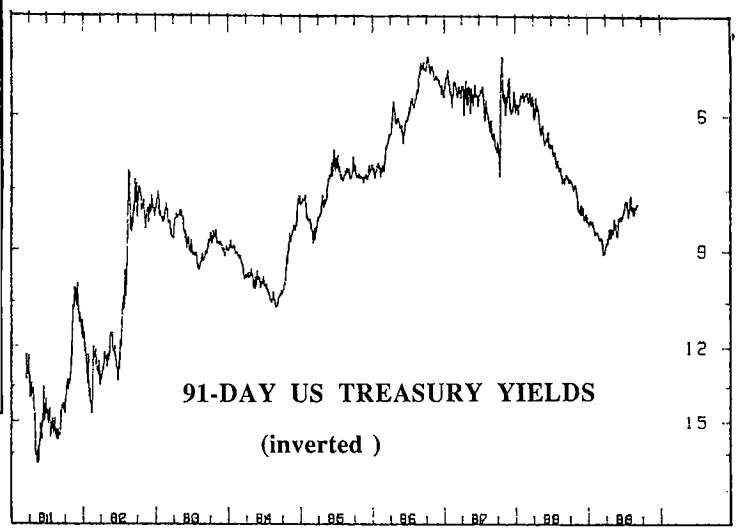
The culprit here is the current corporate hunger for enormous amounts of debt -- plus the additional mountains of debt already assumed in leveraged buy-outs and takeover deals.


Interest costs exceed profits
Nonfinancial corporations
Some of the results of substituting debt for equity are now emerging. In the second quarter, non-financial corporations' interest payments exceeded after-tax profits by a record $25 billion.
In billions of $
160
140
120
100
80
60
40
20
After tax profits
Interest costs
=Recessions
1978 1979 1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990
SOURCE: Bureau of Economic Analysis, Merrill Lynch

So we have to ask the question, "If interest costs today in 'good times' have already surpassed corporate profits, what will happen during the next recession when interest costs hold level or move higher and corporate profits begin sliding in earnest?" (Note: as you can see on the chart, corporate profits are already heading down.)

My answer is that in the next recession we could see a panic for money, with money being borrowed to keep many highly-leveraged corporations afloat. This panic for money could easily move interest rates UP.

I think if you were to search for the most widely-held opinion in the nation, it would be this: "If business slows down, interest rates will collapse." To my mind, this chart suggests otherwise. This chart suggests that in the next recession, interest costs will press many corporations to the wall. In that event, these corporations will do anything, pay any price, to obtain money in order to stave off bankruptcy. That panic for money could drive interest rates up -- not down. This could be the ultimate shocker in our financial future.



The second chart was run off for me by my friend, John Carder. Here we see a long-term view of the 91-day T-bills with yields inverted. Often, a long-term chart will lead to an entirely different conclusion than a short-term chart. And short-term charts are what are almost always presented when it comes to T-bills. Frankly, this long-term chart looks very weak to me. If this chart pictured a stock's price action, would you buy it?

What we see on the chart is a powerful rise in interest rates from 1987 through early-1989 (don't forget, the chart is inverted). From there we see a very weak recovery as interest rates on the T-bills declined from the 9% area to just below 8% -- where they are now.

Now here's an interesting question -- with all the talk of possible recession or slowdown, why has the decline in T-bill rates been so unimpressive? My own feeling is that all we've seen here is a massive bottoming in T-bill yields. The next recession could send the yield line on this chart down through the recent low -- thereby shocking Wall Street as short-term interest rates are driven to much higher levels.

The third chart is courtesy of Ed Hyman and *C.J. Lawrence* (Ed must keep track of every move in the financial markets from Lichtenstein's inflation rate to the price of rubies in Thailand). This

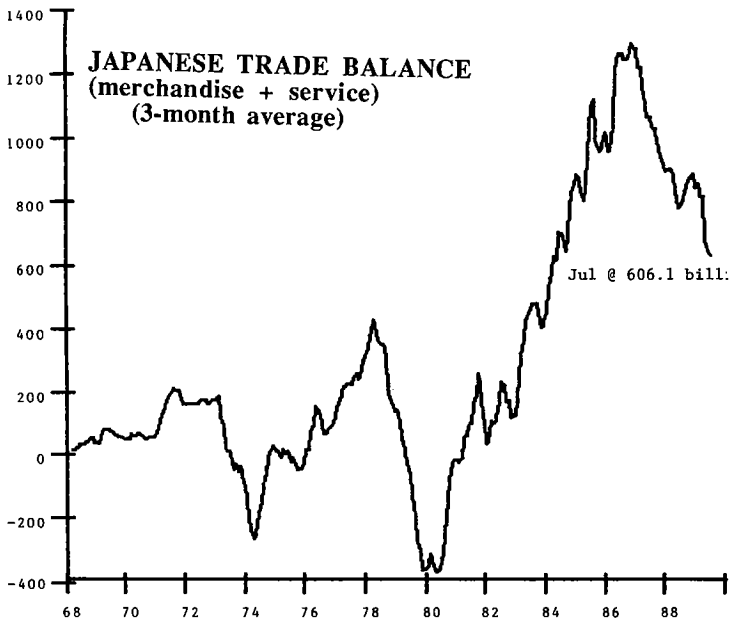


chart is a surprise: Here we see the deteriorating Japanese trade balance, and I mean it is deteriorating, down 51% from the '86 high. In other charts, Ed Hyman shows plunging trade balances in Korea, France, and Canada, with Germany just turning down.

What this could mean is that an international business slowdown is underway. If these major foreign trade balances are sliding, you would think the US trade balance should be improving. We will see shortly.

Question: What do you think would happen to the dollar, interest rates, and bonds if the US goes into recession?

Answer: This is a fascinating question. The widespread opinion is that on any hint of recession interest rates would collapse and the price of high-grade bonds would skyrocket. I'm not at all convinced. And I think this is a perfect area for a contrary opinion.

First, if the US goes into recession I believe the dollar would take a dive. If that happened, bonds would almost surely go down, and then the unthinkable would occur -- interest rates would rise in the face of a contracting US economy.

But why would the dollar decline in the face of a US recession? One reason is simply confidence. Confidence in a nation's currency declines as its economy declines. A second reason is if a recession hits, profits of US corporations would drop, salaries would get squeezed, lay-offs would occur, and the government's tax-take would drop precipitously. As the government's tax-take dropped, its deficits would explode. It wouldn't surprise me to see $400 to $500 billion deficits in the next recession. To cover those kinds of deficits, the government would have to come in with huge new issues of bonds. This too would militate toward a declining bond market and higher, not lower, rates.

These are some of the reasons the Fed is so terrified of a recession. And these are the reasons the government increasingly guarantees or finances every looming disaster on the financial front. They're also the reasons why the US government does absolutely nothing to discourage the ongoing consumer spending binge.

Question: Russell, what about some of the high-yielding money market funds you read about -- I mean the funds yielding over 10%?

Answer: I love high yields as much as anyone. But there are two things to watch out for. A number of these new funds advertise high yields of over 10%, but in order to attract new money they waive their management fees. This gives you a fund with no commissions and no fees. Once the fund's assets are built up, they hit you with the management fee, a fee which can pull the yield down substantially. So read the fine print and see if the management fee is waived temporarily.

Second, some of these funds sweeten their yields with higher yielding bonds, and even with junk bonds. So run down their list of holdings and find out exactly what these high-yielding money funds own. If 20% of the fund is in bonds, check the quality of the bonds. Remember, the new, higher yielding money market funds have not been tested in a recession yet.

Question: The public was traumatized by the 1987 crash, and they have never come back into the market with any real enthusiasm. Yet some analysts insist that this market won't top out until the public returns with both feet. One well-known analyst insists that before this bull market breathes its last and before the public is through with it, the Dow will be up at 5,000. What do you think?

Answer: There's no way in the world that anyone can predict the ultimate top of a bull market or the ultimate bottom of a bear market. Usually, when a market crashes, the public stays out for a decade or even longer. Following the '29 crash, the public didn't come into the market in a big way until the late 1950s (although there was some public participation in 1936-37 and again in 1945-46). But widespread public participation did not appear again until the late-1950s. Likewise, gold and the precious metals crashed in 1980, and the public has not been back in the metals since.

I have thought a lot about this question, and I honestly don't know whether we'll see major public participation in this market before it tops out for good. Up to this point, it would seem that whomever has come back to the stock market has done it via mutual funds. Personally, I think I'd be surprised if the public returned to the stock market again by buying individual stocks. The '87 crash scared them too thoroughly.

As to the ultimate top of the market, the S&P 500 is now selling at over 30 times earnings. Only twice in modern history has the S&P sold above this ratio level -- in 1973 and 1987. The 1973 instance was followed by a severe bear market and the 1987 instance was followed by an historic crash.

Question: How accurate can market forecasting be?

Answer: No one, repeat, no one can see into the future. Even the Bible tells us that: "It is not given to man to know his fate."

One of my pet peeves involves those "gurus" and wanabe-gurus who claim that they can tell us exactly where the stock market is going. In this business, you deal with probabilities and nothing more. The best so-called forecasters in the business do a lot of research and end by offering only educated guesses.

I've said this before, and I'll repeat it. There are NO GENIUSES in the stock market, only geniuses for a while. In my 40 years of

watching and reading market analysts, I've seen many analysts gain prominence with one or more great calls. I've seen many analysts become the talk of Wall Street and the nation. But I've never seen any of these people stay at the head of the class. Sooner or later, they make boo-boos and wrong calls, and they then descend to the level of mere mortals.

As a general rule in this business, the more positive the pronouncement, the bigger the quack. Veteran investors have learned to be wary of "the guru with the answers." Seasoned investors want intelligent discussions with probabilities regarding the future. On the other hand, the public wants certainty, and they'll follow any quack who tells them he has the answers.

Question: A subscriber writes, "Do you think that US Government debt securities are the ultimate junk bonds? After all, there are no assets backing these 'top grade' securities, except for the full faith and credit of the US Government, which is broke. Plus, who can 'have faith' in any of our politicians, those masters of 'Give everyone a bailout?' "

Answer: US Government securities differ in one important way from junk bonds. US securities will always pay off -- even if the government has to print more money to satisfy the debt. The obvious question is, however, "Pay off with what?" Over the years, the dollar has been a depreciating currency in terms of what it will buy. When I was a kid, every man dreamed of earning $10,000 a year -- that was to be a financial success. During WW II GIs were encouraged to buy the famous GI $10,000 insurance policy (I still have mine). That insurance policy was supposed to offer financial security for our old age. Nuff said.

If the trend continues, the US dollar could turn out to be the ultimate "junk currency." And, of course, all US securities are denominated in US dollars. But why do I single out the dollar rather than other currencies? Because the dollar is the world's reserve currency, and because you and I and the majority of Americans depend heavily on the purchasing power of the dollar.

And because the dollar is the world's reserve currency, it should be above reproach; it should be immune to inflation. The fact is that it's scandalous to have the world's reserve currency lose purchasing power.

The history of nations can be traced by the strength or weakness of their currencies. If the dollar goes down the drain, if our trading partners start selling dollars instead of collecting them, the US will become an economic "has-been." And sadly, every time Congress is forced to raise the US federal debt limit, we move nearer to has-been status.

REAL ESTATE: I've said many times that the wealth of America lies in its real estate and more specifically in the homes of Americans. Ever since WW II (with only minor interruptions), the price of homes, fed by continued inflation, has been heading higher. This has spurred massive construction and building, and more recently overbuilding. Now the big question -- is disinflation here, and has the era of price appreciation in US housing ended?

The jury is still out on this one. But from reports all over the nation the story is -- "housing is soft," and in many areas it's most defininitely a buyer's market. From the September 15 *Baxter* report: "I noted that Maine and New Hampshire have something in common with the rest of the states in the union. It seems that half of the houses here are up for sale. It doesn't matter whether you are on the main roads or the hidden little byways. There are 'For Sale' signs everywhere."

Last week Faye and I had dinner with a friend who had just returned from a house-hunting trip to Phoenix. "I was flabbergasted," he said. "It's like a depression. Everywhere you looked there were homes for sale, and for sale at drastically reduced prices. It was scary."

In NYC prices are softening and many condos are now for sale at substantial concessions from earlier prices. In Denver, prices are weak to very weak. It's the same story over most of the Southwest (Southern California being the big exception).

On top of this, we have the S&L disaster with its mile-long list of real estate for sale. Furthermore, banks have huge inventories of houses to sell, and in many cases the banks themselves are in poor shape (commercial banks are failing at the rate of over 200 per year).

Can all this for-sale and distressed property be disposed of in an orderly manner -- even it it takes years to do so? I don't have the answer, but I believe the answer lies with the primary trend of the stock market. If we go into a bear market, I fully expect housing across the nation to be a disaster. However, if the primary trend remains up, the real estate picture may yet resolve itself favorably.

I might add that one problem in real estate is seen in the "affordability index" put out by the National Association of Realtors. From 79.9% at the end of the fourth quarter 1988, the index has dropped to 71% in the April-June period. This means that currently the typical first-time buyer has only 71% of the income necessary to buy a new home.

NOTES & QUOTES: The word out of Russia is that conditions are "so bad that the Brezhnev '70s are remembered as a time of plenty." Soap, razor blades, underwear, many food items are on the scarcity list, while inflation roars almost out of control. Says *The Economist*, "Rubles are becoming less and less like real money and more and more like lottery tickets; you never know what you'll be able to buy with them." Furthermore, the Soviet budget deficit is running about 13% of GNP -- which is HIGH.

If this continues, informed observers are giving Gorbachev six months to a year before he exits the scene. But sensing this, Gorby just received approval to advance the date of the party congress by four months to October 1990, at which time he plans to purge more of his opponents. Gorby's big problem -- can he make Russia work without resorting to an outright move to capitalism? Time will tell, but time is running out on Mr. Gorbachev.

* *

I continue to be fascinated by personal accounts of conditions in Russia from people who have been there recently. This from a judge with whom we had dinner last week: "I can just take a week of Russia. It's so depressing. When you go there you have to realize that you're visiting a Third World country."

* *

And these excerpts from a letter received from a subscriber today: "Just came back from a fabulous two week trip to Moscow and Leningrad -- my own guide in each city. I got more information this way than from a group tour. The ruble is an impediment, being urinated on not only by tourists (official rate is $1.70 per ruble, steet corner rate is 7 to 12 rubles per dollar) but by the Russians themselves. I changed no dollars to rubles, borrowing package mailing charges and metro fare from my guide, repaying her in purchases at a hard-currency store, mainly video cassettes she could get triple-cost for in rubles. I used audio cassettes for tips to waiters and drivers.

"Shopping is the biggest problem for Moscow residents. I investigated fruit/vegetable markets, noting that reasonable or 'state' prices were only for garbage. A long line develops when something edible appears at a 'state' vegetable stall. Collective Association produce may be several times the state prices and usually are really beautiful -- prices are out of sight, however, and people rarely buy. State price for tomatoes is about 70 cents a pound -- collective price $1.70 per pound. As for Moscow/Leningrad restaurant meals, I was, after sampling various versions of soups, meats, fish, and appetizers, finally depending on a survival diet of blini (pancakes) rolled around black caviar and washed down by less-than Brut Russian Champagne. I could find no mushrooms or fruit in any of the so-called de luxe Moscow hotels.

"For shopping, it's a matter of grabbing anything decent. I was fortunate in a newly opened bookstore, in some hand-painted trays, in some lacquered bowls and some pretty wooden toys for children. All had to be packed at a post office for mailing back home -- they don't trust you. It took a half day at a small PO in a very large hotel -- the international PO was impossible. And how about Aeroflot, the Russian airline baggage handlers who make Moscow to Leningrad travelers wait 45 minutes for baggage, delivering only 2-3 plane loads at a time! Glad to finally escape!"

* *

Taking It Easy: In 1950, 45% of US men and 10% of US women in the 65 and over group continued working. Today in the 65 and over group, only 17% of the men and 8% of the women work. Main reason: Mandatory retirement at many firms. Problem: This process results in fewer and fewer Americans supporting an expanding group of over-65s on Social Security.

* *

Last Wednesday I drove up to Los Angeles to see my daughter, Betsy, who had just had a birthday. "I'll miss traffic," I chuckled. "I'll leave San Diego at 4:30 a.m." Which is exactly what I did. At 5:30, to my astonishment, the freeway started to fill up. By 6 a.m. (I was on the outskirts of LA), traffic started to choke and stall. I arrived at 7 a.m. and was lucky to get there (at Sherman Oaks).

On the way back to San Diego I fooled 'em. I left LA at 12:30 AM and this time traffic wasn't too bad. Halfway back to San Diego (around 1:45 a.m.) the roads were actually clear. I arrived home at 2:30. Moral: If you want to travel to and from LA, the best time to do it is after midnight. Just make sure your gas tank is full and you've had at least three hours of sleep.

* *

Man's Best Friend's Worst Enemy: During the last Olympics S. Koreans were told to cool it as far as eating one of their favorites -- dog meat (they were told that the rest of the world liked dogs, and dog-eating was bad public relations). But with the Olympics over the S. Koreans are reverting to form. For 1989, according to Shin Koo Bum, the agricultural minister, Korean consumption of dog meat will reach some 33,000 tons.

* *

With my wife, Faye, in her last year of law school, I'm getting all kind of insights into the law and the life of law students and lawyers (in fact, I'm beginning to feel like a paralegal). One thing I note is that all the big national law firms are rushing to open branch offices in San Diego (San Diego is a super-growth area). "What does this mean?" I asked Faye. "Is everybody in San Diego going to be suing everybody else?" "That's what's happening," she replied.

* *

My friend, Jim Grant (*Grant's Interest Rate Observer*) is as skeptical of today's monster-debt as I am. In his Sept. 15 report, Jim states that "the junk market is the most visible expression of the financial philosophy of the 1980s." That philosophy, says James is that "(1) Everybody deserves a loan; (2) You can always refinance a debt . . . ; and (3) The rate at which you borrow need have no relation to the rate at which you earn."

* *

Japan has flooded its markets with liquidity for years. But today inflation is becoming a problem in Japan (as it is in Germany), and both of these nations have moved toward stricter monetary policy. This policy is pointing to higher interest rates overseas and a declining rate of money supply growth. What does this mean for the US? For one thing, it means rising pressure on the dollar.

* *

America's Alaskan oil production is over the top, and from here on Alaskan oil production will be on a downward course. Meanwhile, the oil rig action in the US continues to drag along the bottom. The fact is that the US is becoming increasingly dependent on OPEC (which has not collapsed as so many have long predicted). All this has not been lost on the oil market. Somewhere ahead I look for another "oil crisis." That could correspond to any breakout in oil above the $21 level.

* *

From a subscriber who was a "former Australian businessman" comes these rather frightening comments about Australia: "The federal government sets the wages for the entire country (via a thing called the 'Arbitration commission'), and they give everyone a pay raise every six months . . . . When your staff goes on leave, you must (by law) pay them an additional 17.5% on top of salary for not being there . . . 55% of the population either works in the civil service or is on some form of government welfare . . . The present annual increase in the money supply is 24%." Russell comment: I believe they have cut back on money creation, but this letter settles it -- I'm not going to open a business in Australia.

* *

Computerized cars and special highway systems are the wave of the future. Japan is moving ahead in all fronts. These include a $700 million Intelligent Vehicle System featuring communications between cars and traffic-management computers. Meanwhile, Japanese car-makers are working with special computer-information systems for the highways. . . . Five European governments are sponsoring the Prometheus Project, an eight-year $875 million program to develop an experimental highway network, while 14 car-makers and 70 technology firms are coordinating work on the project. Large-scale testing is going on in London and Berlin. . . . The US has no such national plan or initiative.

* *

What's the world's hottest economy and stock market? Probably Taiwan. The following is from the *Fraser Opinion Letter,* Box 494, Burlington, VT 05402. The Taiwan stock market has increased 100% in each of the last three years -- 900% since 1986, and its market capitalization is $220 billion, fourth behind Tokyo, NY, and London. The market cap of Taiwan's three largest banks exceeds that of Citicorp. Speculation in Taiwan is intense, fanned by 120 brokerage houses. Personal savings rate in Taiwan is 40% and the nation's trade surplus was $20 billion in 1987, $14 billion in '88. Taipei real estate has doubled or tripled in the last three years -- a 1,300-square-foot home today costs over $325,000. The only way foreign investors can buy into the Taiwan markets is via four mutual funds, two of which are listed on the NYSE (Taiwan Fund and the ROC Taiwan Fund).

* *

Who would turn down a guaranteed $8 million? Dustin Hoffman would and did. That's what he was offered if he would do the Penguin in the British sequel to "Batman." Said the Hoff, "I don't care how much I'm offered. I'm not interested in films at the moment."

* *

Finally: Last week JP Morgan added $2 billion to its bad-debt reserves to cover LDC loans and took a $1.8 billion third-quarter writeoff. Morgan now has reserves equal to 100% of its loans to struggling nations. After the announcement S&P revised Morgan's rating back to AAA, the only large bank in the US to have that rating. This put pressure on other big banks. Earlier in the week Manufacturers Hanover put $950 million aside for bum loans, but this only increased its protection to 36% of LDC loans. The Morgan action was the bank's way of saying that the loans were uncollectible, a dead loss.

* *

Either Rudi Giuliani or Dave Dinkins will be NYC's next mayor. Rudi, the Republican, will have problems since the City is 80% Democrat. Dinkins, a highly-qualified black and Manhattan's borough president, won his candidacy this way. He got 89% of NY's black vote, 62% of the Asian vote, 55% of the Hispanic vote, 27% of the Jewish vote, 60% of the women's vote, and a whopping 74% of those under the age of 25.

One reason Koch was defeated says *US News & World Report* was that the "sense of decline (in the City) after three Koch terms hurt him." What sense of decline? States the magazine: "Since the 1987 stock market crash NY has lost more than 15,000 financial jobs; between 1982 and '88 the city lost 72,000 blue collar jobs. Meanwhile, housing and education costs have risen dramatically, and life has gotten tougher in NYC. More than 50,000 New Yorkers are homeless, 700,000 are drug addicts, and 1988 witnessed more than 90,000 drug-related arrests and 1,896 murders, the city's highest rate ever."

* *

My old friend, Elliot Janeway, is anything but hopeful about the economy. This from the latest *Janeway Letter* (15 E. 80th St., NY

10021): "Find a full segment or for that matter, a region, with any strength left. Failing that, find an industry of consequence still confident enough of its position betweeen suppliers and customers to be aggressively accumulating inventories instead of lowering sights in the hope of liquidating them. Find one September in which GM shut a plant, or in which Alcan and Alcoa cut aluminum ingot prices, that did not signal a major reversal."

* *

Industry Forecasts (the Levys of Chappaqua, NY) in the latest report states: "An increasing number of businesses are being pinched by narrowing profit margins. Before the middle of 1990, prices will be slashed to move inventories, capital expenditure programs will be pared, and layoffs will be widespread in order to cut expenses." If they're not talking about recession, it's something close to it.

* *

The latest US trade balance (July) shows an "improvement" to a negative $7.6 billion, down from June's $8 billion. But it wasn't good news. The improvement came from a 3.5% drop-off in imports, while exports dropped 1.8%. Thus, Americans were buying fewer foreign goods, even while we were selling less to foreigners.

* *

It may be coincidence, but after founder Sir William Lyons died a few years ago, Jaguar's styling and earnings went downhill (Jaguar may show a loss for 1989). Now a number of firms are moving to take over Jaguar, including Chrysler and Ford.

* *

Meanwhile, the famous VW Beetle is not dead. The Beetle is still being manufactured in Mexico, and with a recent 20% cut in price (the Beetle sells for $5,500 in Mexico), demand for the car has exploded. VW-Mexico President Josephi stated, "Our dealers have never had a situation like this." VW built 21,000 Beetles in Puebla, Mexico (the only plant still producing the car), and they plan to turn out 100,000 Mexican Beetles next year.

GOLD: In his October 2 *Forbes* column, Ashby Bladen writes: "The bailout of the thrifts, the weakest of the real estate lenders, shows us how disaster can be postponed indefinitely. The federal government is already the real estate holder of last resort in the Southwest because it cannot sell its foreclosed properties without depressing prices even further, and all it has to do is extend that policy to the rest of the country. But the cost of doing that will be enormous, and it will fall on us, the taxpayers. . . . We are on the brink of a major deflation in real estate values, but for half a century the policy of our government has been to avoid deflation at all costs. The cost of preventing the real estate crash will not only be unprecedented but it will take government policy into uncharted waters."

Russell comment: The main wealth and assets of the American people lie in the value of their homes. If Ashby Bladen is right, if we have a major real estate deflation, we are also going to have a depression. Furthermore, if real estate deflates our banking system and our insurance companies (they hold the mortgages) will be in tatters.

But, if the government decides, as it did with the S&Ls, to prop the banking and insurance systems up, that's going to take a massive amount of new government borrowing and hundreds of billions of dollars of deficit financing. Either way, we'll see massive pressure on the dollar.

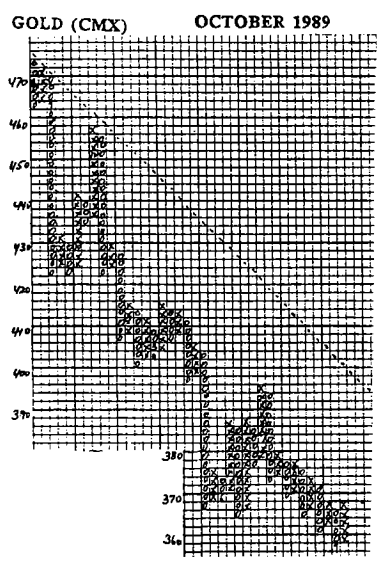
If the dollar caves in, gold is going to take off to higher levels. If the banking system collapses, if government deficits shoot up into the wild blue yonder, gold is going to again look like the only real store of value.

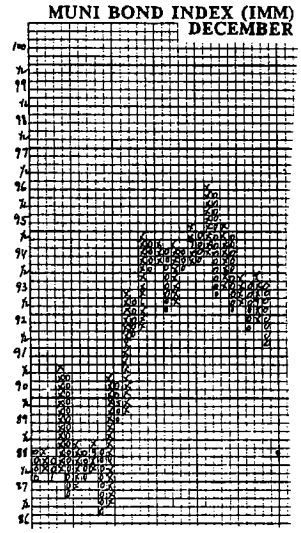
Remember this: gold is the only true money. Gold isn't money by the grace of a government edict (as all paper money is). Furthermore, gold has no debts or liabilities against it. Gold is totally liquid, and it can be sold at any time of the day or night in any quantity. Furthermore, the bigger the crisis, the worse the bankruptcy, the greater the emergency, the easier it is to sell gold.

The easiest way of looking at gold is probably via the point and figure chart of the October (literally spot) gold contract. (Chart courtesy of *Chartcraft*, PO Box 2046, New Rochelle, NY 10801.) Here we see the long decline with basing action in the 360 area. Note that in the previous break below the 424 support area, gold plunged. Then, when gold broke below the 420 support level it plunged again. But, most recently, when gold broke below the 366 support level, the drop was minimal -- down to 358, from which there has been a good recovery. In other words, downside momentum for gold seems to be ebbing (a prerequisite prior to an upside reversal).

The perimeters are now close and clear. A drop below 358 would be bearish for the metal. On the other hand, a rally to the 370 level would be bullish in that it would take gold above two preceding peaks.

As you can see, the main declining or bearish trendline for gold is now around the 400 level. This is the level that gold would have to rally above in order to turn unquestionably bullish. But I think the main thing this chart shows is that gold may be building a base, and that the downward momentum for gold appears to have halted.





BONDS: I have also included the P&F chart for the December municipal bond contract. Here we see a definite breakdown from a "head-and-shoulders" top. How important this top is, obviously, no one can judge at this time. But it does stand as a warning that we have seen the highs on munis for quite some time. An upside breakout on the December muni contract would require an advance above 96 1/2. On the other hand, a reconfirmation of the downtrend would require the December contract to hit 91. Let's watch it.

LATE NOTES: The correction in breadth continues, although the D-J Averages continue to resist the decline (as does my PTI).

The Wall Street gurus disagree violently on what's next for the market. Joe Granville insists that "the market has never recovered from such a shrinkage (he's talking about daily new highs) without either going into a massacre or crashing downside price movement." On the other hand, P.Q. Wall (by all means read the article about the Street's newest guru in the Oct., 2 *Barron's)* believes there could be a substantial rally first before the market collapses.

Meanwhile, the public appears highly confident that all is well, and they are stepping up mutual fund buying at an enormous rate (although the public does seem to prefer bond and income funds to stock funds). As far as the pros go, their speculations go on and on -- the latest being the ridiculous rush into and then out of single-country closed-end funds (at its recent high, the Spain Fund sold for 160% of assets).

NEXT MAILING: Wednesday, Oct. 18